Supreme Court, U.S.
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No. 97-966

In The

Supreme Court of the United States

October Term, 1997

CATERPILLAR INC.,

Petitioner,

v.

COMMISSIONER OF REVENUE,

Respondent.

On Petition For Writ Of Certiorari To The Minnesota Supreme Court

BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether Petitioner failed to establish that the Minnesota corporate franchise tax facially discriminates against foreign commerce in violation of the Foreign Commerce Clause?

2. Whether Petitioner failed to establish that the Minnesota corporate franchise tax discriminates against foreign commerce when applied to Petitioner?

3. Whether Minnesota's non-discriminatory differences in accounting for foreign and domestic subsidiaries are justified?

TABLE OF CONTENTS

Page

QUESTIONS PRESENTED i

TABLE OF AUTHORITIES iv

OPINIONS BELOW 1

JURISDICTION 1

STATEMENT OF THE CASE 2

Minnesota's Corporate Franchise Tax System 2

Proceedings Below 4

REASONS FOR DENYING THE WRIT 5

I. Petitioner Failed To Establish That The Minnesota Corporate Franchise Tax Facially Discriminates Against Foreign Commerce In Violation Of The Foreign Commerce Clause 6

A. The Established Standards 6

B. The Minnesota Supreme Court Applied The Standards Established By This Court And Correctly Held That Petitioner Did Not Show That Facial Discrimination Exists 8

C. The Minnesota Supreme Court Did Not Misapply *Kraft* Footnote 23, Nor Did It Create Any New Test 11

II. As Applied To Petitioner, Minnesota's Corporate Franchise Tax Does Not Discriminate ... 13

III. The Minnesota Supreme Court's Decision Does Not Conflict With Decisions Of Other State Appellate Courts 14

TABLE OF CONTENTS – Continued

Page

IV. Minnesota's Non-Discriminatory, But Different, Accounting For Foreign And Domestic Subsidiaries Is Justified 16

CONCLUSION 19

APPENDIX RA1

TABLE OF AUTHORITIES

Page

UNITED STATES CASES:

Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992) 2

Armco, Inc. v. Hardesty, 467 U.S. 638 (1984) 7

Barclays Bank PLC v. Franchise Tax Bd., 512 U.S. 298 (1994) 6, 7, 16, 17

Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977) 6

Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983) 16, 17

Hughes v. Oklahoma, 441 U.S. 322 (1979) 7

Kraft General Foods, Inc. v. Iowa Dep't of Revenue and Fin., 505 U.S. 71 (1992) ..... *passim*

Maryland v. Louisiana, 451 U.S. 725 (1981) 7, 10

Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980) 16

Norton Co. v. Department of Revenue, 340 U.S. 534 (1951) 7

Quill Corp. v. North Dakota, 504 U.S. 298 (1992) 7

STATE CASES:

Caterpillar Fin. Serv. Corp. v. Whitley, 680 N.E.2d 1082 (Ill. Ct. App.), appeal denied, 686 N.E.2d 1158 (Ill. 1997) 15

Caterpillar, Inc. v. Commissioner of Revenue, 568 N.W.2d 695 (Minn. 1997) 1

TABLE OF AUTHORITIES – Continued

Page

Caterpillar, Inc. v. Commissioner of Revenue, No. 6633, 1996 WL 666654 (Minn. T. Ct. Nov. 14, 1996) 1

Conoco, Inc. v. Taxation & Rev. Dep't, 931 P.2d 730 (N.M. 1996), cert. denied, 117 S.Ct. 2497 (1997) 14

Dart Industries, Inc. v. Clark, 657 A.2d 1062 (R.I. 1995) 15

E. I. Du Pont de Nemours & Co. v. State Tax Assessor, 675 A.2d 82 (Me. 1996) 15

In re Morton Thiokol, Inc., 864 P.2d 1175 (Kan. 1993) 15

MISCELLANEOUS:

1 CCH State Tax Guide, ¶ 10-115 (3/97) 18

CCH State Tax Reporter, Alaska, ¶ 12-404 (9/96) 18

1 Jerome R. Hellerstein and Walter Hellerstein, State Taxation (2nd ed. 1993) 13, 18

BRIEF IN OPPOSITION

Respondent Commissioner of Revenue respectfully requests that this Court deny the Petition for Writ of Certiorari seeking review of the decision of the Minnesota Supreme Court in this case.

OPINIONS BELOW

The decision of the Minnesota Tax Court is reported in Westlaw. *See Caterpillar, Inc. v. Commissioner of Revenue*, No. 6633, 1996 WL 666654 (Minn. T. Ct. Nov. 14, 1996).

The reproduction of the decision of the Minnesota Supreme Court in Petitioner's Appendix contains a number of typographical errors not present in the reported decision at 568 N.W.2d 695 (Minn. 1997).

JURISDICTION

In its jurisdictional statement, Petitioner incorrectly states that the judgment of the Minnesota Supreme Court was entered September 11, 1997. The decision is dated September 11, 1997, however, judgment was entered October 20, 1997. Respondent's Appendix, p. RA-1. The later judgment date does not affect this Court's jurisdiction.

STATEMENT OF THE CASE

Respondent submits the following additional information to supplement Petitioner's descriptions of Minnesota's tax system and the proceedings below.

Minnesota's Corporate Franchise Tax System.

Each corporation with Minnesota nexus (sufficient contacts with Minnesota) is required to file and pay Minnesota corporate franchise tax (measured by income) on an apportioned basis.[1]

The apportionable tax base for each corporation having Minnesota nexus is determined using the "domestic combination" method of "water's edge" combined reporting. Domestic combination reporting means that the net incomes of all the domestic corporations engaged in a unitary business[2] are combined, resulting in the apportionable tax base. This apportionable tax base thus

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[1] A corporation with sales in Minnesota that lacks Minnesota nexus is not required to file a Minnesota return or pay Minnesota tax even though it is engaged in a unitary business with other corporations that do have nexus with Minnesota. Appellant and two subsidiaries had nexus with Minnesota (Petitioner's Appendix, p. 27a (hereinafter "P. App.")), and each corporation was required to file a Minnesota corporate franchise tax return and pay Minnesota tax (P. App. 30a).

[2] A unitary business exists when there is a flow of value between the various units of the business. The test for a unitary business focuses on functional integration, centralization of management and economies of scale. *See Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 783 (1992) and cases cited therein.

includes the net incomes of the unitary domestic corporations, but does not include the incomes of any foreign corporations.

Because the apportionable tax base is the income of the combined group as a whole, transactions between members of the combined group do not affect the group's combined income. When a subsidiary pays royalties and interest to its parent, the income recognized by the parent is offset by the expense recognized by the subsidiary, thus eliminating the transaction. The apportionable tax base of the combined group includes any income received from a party outside the combined group and any expenses paid to a party outside the combined group. Because foreign corporations (whether unitary or not) are not part of the combined group, royalties and interest received by the group from foreign corporations, as well as expenses paid to foreign corporations, are included in computing the tax base of the group, as are transactions with unrelated third parties.

The apportionable tax base is allocated to Minnesota using an apportionment percentage computed using a weighted, three-factor apportionment formula. The apportionment percentage is computed separately for each reporting corporation. The reporting corporation's Minnesota property, Minnesota payroll and Minnesota sales are respectively divided by the total property, payroll and sales of all corporations included in the combined group, *i.e.* all unitary domestic corporations. The results are weighted and added together to give the apportionment percentage.

For each reporting corporation, the income taxed by Minnesota is determined by multiplying the apportionable tax base of the combined group by the apportionment percentage of the reporting corporation. Thus, the tax base of the group is apportioned to Minnesota according to the Minnesota activities of the filing corporation, regardless of the amount of income recorded on the books of any individual member of the group. Because the net income recorded by a foreign corporation is not included in the combined group's tax base, none of the foreign corporation's income is, or can be, apportioned to Minnesota through the apportionment formula. Similarly, because the net income of the foreign corporation is not included in the combined group's tax base, the property, payroll and sales factors of the foreign corporation are not used to apportion the income of the combined group among the members of the combined group and among the states in which the members do business.

Proceedings Below.

In its statement of the proceedings below, Petitioner states that it filed amended Minnesota corporate franchise tax returns claiming refunds. Petition, p. 6. This should not be misunderstood to imply that Petitioner's amended returns demonstrated discrimination. In its amended returns, Petitioner merely excluded from income all the royalties and interest it received from its foreign subsidiaries.[3] Petitioner did not show, or even

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[3] The Minnesota Supreme Court incorrectly described the amended returns as including the foreign subsidiaries' apportionment factors. P. App. 5a. The misdescription did not

claim, that its tax burden was greater because some of its subsidiaries were foreign rather than domestic corporations. Nor did Petitioner subsequently make any such claim or showing. P. App. 15a.

REASONS FOR DENYING THE WRIT

Petitioner seeks review on grounds that the Minnesota Supreme Court (and other state courts) misapplied footnote 23 of *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance*, 505 U.S. 71, 80 (1992) and did not apply the proper test to determine whether there is impermissible discrimination under the Foreign Commerce Clause. Petition, p. 11.

The writ should be denied. This Court's standards for determining discrimination are well-established, have been recently considered and applied by this Court, and were correctly applied by the court below. In making its determination, the court below did not create any "new test," as Petitioner claims, nor did it misapply footnote 23 of *Kraft*. Petitioner did not show facial discrimination.

Moreover, review of this case is inappropriate because Petitioner has not even established that it is adversely affected. Thus, the tax is non-discriminatory as applied and Petitioner is an unsuitable litigant.

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affect the court's decision as the court correctly concluded that Petitioner did not show that its tax was any higher because its foreign subsidiaries were not taxed like domestic ones. P. App. 15a.

Further, review is not needed to resolve any conflict between the decisions of lower courts. All the decisions of other state appellate courts are consistent with the decision below.

Finally, Minnesota's non-discriminatory, but differential, accounting for foreign and domestic subsidiaries is supported by compelling public policies and state interests.

I. Petitioner Failed To Establish That The Minnesota Corporate Franchise Tax Facially Discriminates Against Foreign Commerce In Violation Of The Foreign Commerce Clause.

Petitioner alleges that Minnesota's corporate franchise tax facially discriminates against foreign commerce. Petitioner's claim rests entirely upon the non-discrimination component of Foreign Commerce Clause jurisprudence. However, Petitioner does not apply the standards established by this Court to determine whether a tax discriminates against foreign commerce. The court below did apply the proper standards and correctly determined that Petitioner did not show that discrimination exists.

A. The Established Standards.

The non-discrimination component of Foreign Commerce Clause jurisprudence has been recently considered and applied in *Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298, 310-11 (1994) (*citing Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977)). The non-discrimination component prohibits "taxes that pass an unfair

share of the tax burden onto interstate [foreign] commerce," *Quill Corp. v. North Dakota*, 504 U.S. 298, 313 (1992) or taxes that "systematically 'overtax[ ]' foreign corporations." *Barclays*, 512 U.S. at 314. A law is discriminatory if it taxes interstate commerce more heavily than intrastate commerce, *see Armco, Inc. v. Hardesty*, 467 U.S. 638, 642 (1984), or foreign commerce more heavily than domestic commerce, *see Kraft*, 505 U.S. at 79-80.

In determining whether foreign commerce is more heavily taxed, a court must consider "the operation of other provisions of the . . . statute" under review. *Kraft*, 505 U.S. at 80-81 (quoting *amicus* brief of the United States with approval); *see also Maryland v. Louisiana*, 451 U.S. 725, 756 (1981) (a tax must be evaluated in light of the other provisions of the tax scheme).

This Court has specifically shown the proper comparison to be made in cases like this one. The appropriate comparison is between the tax imposed upon a corporation having a foreign subsidiary and the tax on one having a domestic subsidiary that does not do business within the state. *See Kraft*, 505 U.S. at 80 n.23.

Finally, the burden of showing that foreign commerce is more heavily taxed is on the party claiming discrimination. *See Hughes v. Oklahoma*, 441 U.S. 322, 336 (1979); *Norton Co. v. Department of Revenue*, 340 U.S. 534, 537 (1951) (taxpayer claiming constitutional immunity from tax has burden of establishing it).

This Court's standards are well-established and have been recently considered and applied by this Court. There is no need to revisit these standards.

B. The Minnesota Supreme Court Applied The Standards Established By This Court And Correctly Held That Petitioner Did Not Show That Facial Discrimination Exists.

Petitioner alleges that Minnesota's corporate franchise tax facially discriminates against royalties and interest received from foreign subsidiaries. However, Petitioner does not apply the standards established by this Court.

The Minnesota Supreme Court did apply the proper standards and correctly determined that Petitioner did not show that discrimination exists. P. App. 6a-7a, 10a-11a, 13a-15a. It compared the Minnesota franchise tax imposed upon a corporation having a foreign subsidiary with the tax on a corporation having a domestic subsidiary. P. App. 10a. It considered "the operation of other provisions of the . . . statute" under review, citing *Kraft*, 505 U.S. at 80-81 (quoting *amicus* brief of the United States with approval). P. App. 13a. It also imposed upon Petitioner the burden of showing that foreign commerce is more heavily taxed than domestic commerce. P. App. 10a.

Following the decisions of this Court, the Minnesota Supreme Court correctly considered *all* of the provisions of the Minnesota corporate franchise tax. It considered that Minnesota completely excludes the income of foreign subsidiaries from the combined group's apportionable tax base, thus reducing the tax base and ensuring that none of the income recorded on the books of a foreign

subsidiary is apportioned to Minnesota.[4] This lower tax base lowers the Minnesota tax.

When all of the provisions of the Minnesota corporate franchise tax are taken into account, Petitioner cannot show facial discrimination. While the exclusion of a foreign subsidiary's factors increases the tax, the exclusion of its net income from the tax base decreases the tax.[5] When both the apportionment formula and the entire tax base are considered, it is not possible to establish that the Minnesota corporate franchise tax will be higher for a parent corporation with a foreign subsidiary than for a parent corporation with a domestic subsidiary. A parent corporation with a foreign subsidiary may pay more or less tax than a parent with a domestic subsidiary. Whether the tax is higher depends upon many independent facts, including: the income of the parent; the income of the subsidiary; the property, payroll and sales

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[4] The Minnesota Supreme Court observed that Petitioner is taxed with respect to the royalties and interest received from its foreign subsidiaries just as it is taxed on any royalties and interest it may receive from unrelated corporations. P. App. 9a. This identical treatment is significant because it shows that Minnesota's franchise tax is structured to avoid taxing the income of foreign subsidiaries. Just as Minnesota's tax is structured to tax Petitioner only for Petitioner's income and not for income of unrelated corporations which make payments to Petitioner, Minnesota's tax is structured to similarly avoid taxing Petitioner for the income of its foreign subsidiaries.

[5] This assumes positive net income. If one assumes net losses, then the impact is reversed: the higher apportionment percentage lowers the tax and the smaller apportionable income base increases the tax.

factors of the parent; the property, payroll and sales factors of the subsidiary; the amount of royalties and interest paid by the subsidiary to the parent; and the nature and amounts of other transactions between the parent and subsidiary. Whether or not the tax will be higher or lower for a parent with a foreign subsidiary depends upon which of the infinite combination of these elements is present in a particular case. The fact that the tax may be higher or lower shows that Minnesota's corporate franchise tax system does not discriminate against foreign commerce.

As it did in the court below, Petitioner fails to consider the operation of the entire Minnesota corporate franchise tax statute in its analysis. Petitioner focuses only on a portion of the tax base and on the apportionment formula. Petitioner correctly notes that a parent corporation's apportionment percentage is lower when the parent has a domestic subsidiary than when it has a foreign subsidiary. However, Petitioner's analysis is incomplete and incorrect because Petitioner only applies these percentages to the amount of any royalties and interest received from the subsidiaries.

Petitioner's analysis is contrary to the decisions of this Court because Petitioner fails to consider the *entire* Minnesota corporate franchise tax statute. *See Kraft*, 505 U.S. at 80-81; *Maryland v. Louisiana*, 451 U.S. at 756. Specifically, Petitioner fails to consider that while the apportionment percentage is higher when a subsidiary is foreign, the apportionable tax base is lower because the income of the foreign subsidiary is *excluded* from the apportionable tax base of the combined group.

Petitioner's statement that "it is indisputable that the Minnesota system treats interest and royalty payments received from foreign subsidiaries . . . less favorably than interest and royalty payments received from domestic subsidiaries" (Petition, p. 12) simply misapplies the standard for determining discrimination established by this Court and does not consider the entire statute.

Review of the decision below is not necessary because the Minnesota Supreme Court applied the standards established by this Court and correctly held that Petitioner did not show that discrimination exists.

C. The Minnesota Supreme Court Did Not Misapply *Kraft* Footnote 23, Nor Did It Create Any New Test.

Petitioner inaccurately portrays the decision of the Minnesota Supreme Court as misapplying *Kraft* footnote 23. Petition, pp. 9, 11, 15. Without a citation to the opinion below, Petitioner states that the Minnesota court based its decision on "the misguided ground that footnote 23 in *Kraft* has effectively precluded a finding of facial discrimination under the 'water's edge' method." Petition, p. 11. This statement is incorrect. The Minnesota court noted *Kraft* footnote 23 in a footnote of its own. The Minnesota court stated that it found *Kraft* footnote 23 "instructive by analogy to royalties and interest." The court quoted the footnote which states that it would be difficult to say that Iowa discriminates against a business with a foreign subsidiary in a situation in which "Iowa would tax an apportioned share of the domestic subsidiary's entire earning, but would tax only the amount of the foreign subsidiary's

earnings paid as a dividend to the parent." P. App. 14a, quoting *Kraft*, 505 U.S. at 80 n.23. This is not a misapplication of the footnote, nor does it indicate that the footnote precludes a finding of facial discrimination. After reviewing Petitioner's argument and the submitted facts, the Minnesota court concluded that Petitioner simply failed to show that discrimination exists.

Petitioner also claims that the court below "fashioned an entirely new test for establishing impermissible discrimination." Petitioner claims that the court below required Petitioner to show that its tax was greater than a hypothetical tax method not adopted by Minnesota. Petitioner then cites cases which hold that a taxpayer need not compare its tax with a hypothetical one or prove the amount of discrimination once discrimination has been shown. Petition, pp. 21-22.

Petitioner incorrectly describes what the Minnesota Supreme Court did. The Minnesota court correctly compared the Minnesota franchise tax on a corporation having foreign subsidiaries with the tax on a corporation having domestic subsidiaries. It correctly concluded that Petitioner had not shown that the tax was greater for the corporation having foreign subsidiaries and therefore, there was no discrimination. P. App. 15a. This is not "an entirely new test" but rather the test established by this Court and applied in *Kraft* to determine whether a tax discriminates against foreign commerce. The court below applied the standards established by this Court, and correctly held that Petitioner did not show facial discrimination.

Petitioner argues that the court below incorrectly concluded that it would be inappropriate to include the

factors of the foreign subsidiary in the parent's apportionment formula because all the income of the subsidiary is excluded from apportionable income. Petition, pp. 18-20. Petitioner's argument does not consider that the royalties and interest received by Petitioner are income of the combined group and it is the income of the combined group that is being measured, apportioned and taxed. When paid by the foreign subsidiary, the royalties and interest are not income of the subsidiary. Rather, they are expenses of the foreign subsidiary which reduce its income.

Opposing counsel has acknowledged that there is no reason to include the apportionment factors of a related royalty payer in computing the recipient's apportionment percentage:

> [T]here is no more reason to include in the apportionment of a recipient of royalty payments the factors of the affiliated payor in a unitary business than there would be to include the factors of a non-affiliated royalty payor.

1 Jerome R. Hellerstein and Walter Hellerstein, *State Taxation*, ¶ 9.13[3][a], at 9-84 n.289 (2nd ed. 1993).

The court below did not err and review is unwarranted.

II. As Applied To Petitioner, Minnesota's Corporate Franchise Tax Does Not Discriminate.

In addition to reviewing Petitioner's facial challenge, the court below held that Petitioner did not even show that it was adversely affected by the statute. In doing so,

the court below compared the Minnesota franchise tax imposed upon Petitioner (having foreign subsidiaries) with the franchise tax imposed upon a parent corporation with domestic subsidiaries. It also applied the rule that Petitioner had the burden of showing that foreign commerce is more heavily taxed than domestic commerce. Applying these standards, the court correctly determined that Petitioner did not even show that its Minnesota tax would have been any lower had its foreign subsidiaries been included in the combined group with its domestic subsidiaries. P. App. 14a-15a.

Petitioner's failure to show that it has suffered any adverse effect shows that Petitioner's allegation of discrimination is without merit, that Petitioner merely seeks lower taxes[6] rather than non-discriminatory treatment, and that Petitioner is not an appropriate litigant.

III. The Minnesota Supreme Court's Decision Does Not Conflict With Decisions Of Other State Appellate Courts.

The Minnesota Supreme Court's decision in this case does not conflict with decisions of other state courts. State appellate courts have consistently applied the *Kraft* case to strike down state taxes which discriminate against foreign commerce. *See Conoco, Inc. v. Taxation & Rev. Dep't,*

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[6] Petitioner seeks a refund of Minnesota tax even though Petitioner has never shown that Minnesota's method of accounting for foreign subsidiaries resulted in Petitioner paying more tax than it would have if its subsidiaries had been domestic ones.

931 P.2d 730 (N.M. 1996) (holding that *Kraft* discrimination is not remedied by factor expansion), *cert. denied*, 117 S. Ct. 2497 (1997); *Dart Industries, Inc. v. Clark*, 657 A.2d 1062 (R.I. 1995) (statute indistinguishable from *Kraft*).

When discrimination has not been shown, state appellate courts have upheld state taxes. *See Caterpillar Fin. Serv. Corp. v. Whitley*, 680 N.E.2d 1082 (Ill. Ct. App.), *appeal denied*, 686 N.E.2d 1158 (Ill. 1997) (tax does not discriminate against royalties and interest from foreign subsidiaries where the total net income of domestic subsidiaries is included in apportionable income while the total net income of foreign subsidiaries is excluded); *E. I. Du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82 (Me. 1996) (holding Maine's water's edge combined reporting method does not discriminate against dividends from foreign subsidiaries); *In re Morton Thiokol, Inc.*, 864 P.2d 1175 (Kan. 1993) (Kansas's water's edge combined reporting method does not facially discriminate against dividends from foreign subsidiaries).

In deciding this case, the court below correctly applied this Court's standards for determining discrimination under the Foreign Commerce Clause, and the decisions of other state appellate courts are consistent with it. There is no conflict among the lower courts.

IV. Minnesota's Non-Discriminatory, But Different, Accounting For Foreign And Domestic Subsidiaries Is Justified.

The foregoing arguments show that Minnesota's water's edge combination taxing method does not discriminate against foreign commerce. While water's edge combination is not discriminatory, it does require different accounting methods for domestic and foreign subsidiaries. Domestic subsidiaries are included in the combined group and must therefore include their reported income in the apportionable base while foreign subsidiaries are excluded.

Minnesota's use of water's edge combined reporting is reasonable because available alternative methods – separate accounting or some form of worldwide combination – have severe deficiencies. Separate accounting has all the deficiencies discussed in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 181 (1983) (citing *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 438 (1980)). A form of combined reporting is necessary to overcome these deficiencies.

Although it overcomes the deficiencies of separate accounting, worldwide combination or any of its aspects, such as the use of apportionment factors and other financial information that must be derived from foreign corporations, presents severe problems. First, the worldwide combination method necessitates converting the diverse languages, currency and accounting principles from around the world into the language, currency and accounting principles of the United States, a substantial burden on taxpayers and the state. *See Barclays*, 512 U.S.

at 313 (citing petitioner's brief and the findings below). Second, states like Minnesota lack power over foreign corporations. The United States itself cannot require foreign corporations operating outside the United States to convert their records to the English language, and to United States currency and accounting standards. The difficulty for a state would be far greater. Third, worldwide combination conflicts with the separate entity, arm's length reporting system that the United States and foreign nations have adopted by treaty. *See, e.g., Container*, 463 U.S. at 184. Finally, the use of worldwide combination by states has been opposed by virtually every developed country in the world, *see Barclays*, 512 U.S. at 320, 324 n.22, and the states have been pressured not to use it.

Under pressure from multinational corporations and under the threat of federal legislation, states that previously adopted worldwide combination abandoned it after the *Container* decision. Opposing counsel described this reaction:

> In an ironic twist of history, the victory of the California Franchise Tax Board in the *Container* worldwide apportionment case led to the demise of worldwide apportionment in some States and to its restriction in other States. The ink was hardly dry on the *Container* decision in 1983 when President Ronald Reagan responded to the relentless pressure of multinational enterprises, supported by foreign governments, by convening a Worldwide Unitary Taxation Working Group to review worldwide apportionment. In its 1984 report, the Working Group recommended the adoption by the States of legislation or administrative action that would limit unitary apportionment of both U.S. and foreign-

> based multinationals to U.S. water's edge income. In the event "there are not sufficient signs of appreciable progress by the States" in adopting the agreed principles, Secretary of the Treasury Donald Regan stated that he would recommend Federal legislation that "would give effect to a water's edge limitation."

1 Jerome R. Hellerstein and Walter Hellerstein, *State Taxation* ¶ 8.16, at 8-185 (2nd ed. 1993) (footnotes omitted). Acting with "unusual legislative speed," states changed their laws to adopt some form of water's edge apportionment. *Id.* ¶ 8.16 at 8-185-87. Except for Alaska's special provision for oil, gas and pipeline companies operating there, no state requires worldwide unitary reporting. CCH State Tax Guide, vol. 1, ¶ 10-115 (3/97); CCH State Tax Reporter, Alaska, ¶ 12-404 (9/96).

The foregoing shows that strong policies and state interests justify the use of the water's edge combination method.

CONCLUSION

For the reasons presented in this Brief In Opposition, the Petition should be denied.

Respectfully submitted,

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APPENDIX

STATE OF MINNESOTA

[X] Supreme Court
[ ] Court of Appeals

Caterpillar, Inc.,
Relator,

vs.

Commissioner of Revenue,
Respondent.

JUDGMENT
C6-97-27

Appellate Court Case Number

Trial Court Case Number

Pursuant to an order of Court heretofore duly made and entered in this cause it is determined and adjudged that the decision of Minnesota Tax Court filed November 14, 1996 *be and the same hereby is* affirmed

and that judgment be entered accordingly. A certified copy of the entry of judgment and the Court's decision is herein transmitted and made part of the remittitur.

Dated and signed: FOR THE COURT October 20, 1997
Dated

By: /s/ Wendy Johnson
Assistant Clerk